ORIGINAL

BEFORE THE ARIZONA CORPORATION COMMISSION

COMMISSIONERS

MIKE GLEASON, Chairman
WILLIAM A. MUNDELL
JEFF HATCH-MILLER
KRISTIN K. MAYES
GARY PIERCE

IN THE MATTER OF THE APPLICATION OF ARIZONA-AMERICAN WATER COMPANY, AN ARIZONA CORPORATION, FOR A DETERMINATION OF THE CURRENT FAIR VALUE OF ITS UTILITY PLANT AND PROPERTY AND FOR INCREASES IN ITS RATES AND CHARGES BASED THEREON FOR UTILITY SERVICE BY ITS SUN CITY WATER DISTRICT

DOCKET NO. W-01303A-07-0209

ARIZONA-AMERICAN WATER COMPANY

NOTICE OF FILING INITIAL BRIEF

Arizona-American Water Company hereby files its initial brief in the above-referenced matter.

RESPECTFULLY SUBMITTED on February 13, 2008.

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INITIAL BRIEF OF ARIZONA-AMERICAN WATER COMPANY

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I INTRODUCTION

Arizona-American Water Company ("Arizona-American") is requesting an increase in annual water revenues of $2,023,117, or 26.31%, based on a test year ending December 31, 2006.[1] The increase is needed to recover certain Commission-approved deferred items, increases in plant in service since the last test year (2001), increases in operating and maintenance expenses, again, since 2001, and increases to the Company's cost of capital.[2]

Arizona-American's present financial condition is so difficult that it cannot undertake any discretionary capital investments in Arizona without prompt rate recovery.[3] Arizona-American's equity shareholder, American Water, is supporting Arizona-American through these difficult times with infusions of equity. Arizona-American has a very substantial investment ($125 million) dating back to the late 1990s, of which Sun City Water district's share is not yet in rate base. Furthermore, very substantial refunds are due to Anthem's developer, Pulte Homes, in 2008, and the White Tanks Regional Water Treatment Plant is now under construction. This is on top of Arizona-American's required arsenic-remediation investments in 2006.

Arizona-American presented its case through the testimony and exhibits of five witnesses:

	Name	**Subject Matter**	**Exhibits**	**Testimony**
1	Cindy Datig: Executive Director, Dollar Energy Fund	Low Income Program	A-1	Tr. 92-107
2	Joseph E. Gross: Arizona-American, Engineering Director	Projected Cost of Fire-Flow Projects	A-2	Tr. 107-205

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[1] See Section V, below.
[2] Ex. A-3 at 2:11-14.
[3] This paragraph, Ex. A-3 at 8:1-11; Tr at 1030:17 – 1031:1.

3	Bradley J. Cole: Arizona-American, Director of Operations	System Overview, Fire-Flow Task Force, White Tanks Treatment Plant, Fire-Flow Requirements, Youngtown Water Pressure, Fire-Hydrant Replacement Costs, Water Losses	A-9, A-10, A-13	Tr. 323-350, 561-569
4	Thomas Broderick: Arizona-American, Manager, Rates & Regulatory Affairs	Case Overview, Capital Structure, Cost of Debt, Public-Safety (Fire-Flow) Surcharge, Fire-Flow Survey, Low Income Program, Amortization of Imputed Advances and Contributions, Property Taxes, Rate Case Expense, Achievement Incentive Pay, Rate Design, Miscellaneous	A-3, A-4, A-5, A-11, A-12, A-14, A-15, A-16	Tr. 350-430, 437-560, 1016-1013
5	Linda Gutowski: Arizona-American, Senior Rate Analyst	Rate Base Components, Operating Income Components, Revenue Requirement.	A-6, A-7, A-8, A-11	Tr. 570-603

Arizona-American's final rate-base, operating-income, and revenue-requirement positions are shown in its Final Schedules, filed on January, 14, 2008 (collectively, "AAW Final Schedules"). Staff's final positions are shown in the schedules attached to Exhibit S-22. RUCO's final positions are shown in its Final Schedules, filed on January 21, 2008 (collectively, "RUCO Final Schedules").

During this case the parties were able to work out the vast majority of their initial differences. As a result, the parties' final recommended revenue-requirements positions are extremely close. Almost all of the remaining small differences are attributable to differences in the recommended cost of capital.

II RATE BASE

A POSITIONS OF PARTIES

1 ARIZONA-AMERICAN

Arizona-American supports a rate base of $25,295,922.[4]

2 STAFF

Staff supports a rate base of $25,295,921.[5] The difference with Arizona-American is immaterial.

3 RUCO

RUCO supports a rate base of $25,341,290.[6] The only difference between RUCO and Arizona-American is RUCO's inclusion of a $45,368 balance for cash working capital.

B RATE BASE ISSUES

1 CASH WORKING CAPITAL

This is a RUCO issue. Arizona-American did not request an allowance for cash working capital in this case. There is no requirement that a rate application include a request for cash working capital.

> ALJ RODDA: So can I just ask you directly. Is there a requirement that a company seek working capital, Class A utility request for working capital?
>
> [Timothy Coley]: I can't cite a rule, Commission rule that states that a company can -- has to request working capital -- or cash working capital, two differentiations. The company obviously asked for working capital. They've asked for about 300-something thousand, but they don't want to include cash working capital, which often is the negative impact in cash working capital for Class A companies.
>
> ALJ RODDA: So is it your opinion that, because the cash working capital allowance could be negative, that they should always -- Class A company should always do a lead/lag study?

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4 AAW Final Schedule B-2.

5 Ex. S-22; Schedule AII-3.

6 RUCO Final Schedule TJC-3.

THE WITNESS: That's RUCO's opinion, yes.

ALJ RODDA: But you don't know of a rule that requires that.

THE WITNESS: I don't know of a rule.[7]

Further, by its sufficiency finding, the Staff certified that the application met all the Commission's filing requirements.

Having met the filing requirements, the burden was on RUCO to establish that something other than a zero working capital balance was correct. RUCO has failed to meet that burden.

RUCO maintains that a lead/lag study is needed to calculate cash working capital.[8] But RUCO has failed to provide one. Instead, RUCO suggested that the Commission should accept the results of another lead-lag study that Arizona-American performed for its Mohave Water/Wastewater Districts.[9] RUCO then looked only at revenues to make its adjustments.[10]

RUCO's back-of-the envelope calculation is inappropriate. RUCO even recognizes that purchase water expense "could likely vary."[11] The Mohave Water/Wastewater District lead/lag study was for a district located 200 mile away, and performed several years ago.

Arizona-American and the Staff each recommend a zero balance for cash working capital. If RUCO wished to offer another level for cash working capital, it had the burden of providing credible evidence, in the form of a lead/lag study <u>for Sun City Water</u>, for the Commission to consider.

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[7] Tr. at 842:25 – 843:18.
[8] Ex. R-5 at 14:1-5.
[9] *Id.* at 15:1-6.
[10] *Id.*
[11] *Id.* at 15:10-11.

III OPERATING INCOME

A POSITIONS OF PARTIES

1 ARIZONA-AMERICAN

Arizona-American supports test-year operating income of $708,124.[12] At the hearing, Ms. Gutowski accepted RUCO's reduction for Eastern Division depreciation expense associated with Eastern Division plant that the parties had previously agreed to remove. The net effect is to reduce amortization and depreciation expense by $770, which increases test-year operating income from the $707,308 level in Ms. Gutowski's rejoinder schedules to $708,124.

2 STAFF

Staff supports test-year operating income of $712,233.[13] Because of Staff's lower recommended cost of capital, Staff's property-tax and income-tax expenses are also lower. This has the effect of increasing Staff's test-year income from Arizona-American's level. The only other difference is that Staff's depreciation and amortization expense does not incorporate Arizona-American's $770 reduction at the hearing. Arizona-American does not believe that there are any other differences with Staff concerning operating income.

3 RUCO

RUCO supports test-year operating income of $755,927.[14] The following table reconciles the operating-income differences between Arizona-American and RUCO:

[12] AAW Final Schedule C-2.
[13] Ex. S-22, Schedule AII-4.
[14] RUCO Final Schedule TJC-8.

RUCO Adjustment	Arizona-American Final	Operating Income		$708,125
	Effect	**Issue**		
5	Decrease Property Tax Expense	RUCO Property Tax Methodology	+	$25,999
8	Decrease Management Fees Expense	Annual Incentive Pay	+	$32,230
12	Decrease Tank Maintenance Expense	Late-Filed	+	$27,347
6	Increase Water Revenues. Decrease Fuel & Power, Customer Accounting, Miscellaneous, and Maintenance Expense	Annualization	+	$810
9	Increase Rate Case Expense	3-year v. 4-year amortization	-	$7,856
7	Decrease Misc. Expense	Arbitrary	+	$4,221
16	Decrease Income Tax Expense	Income Taxes	-	$34,949
	RUCO Final	**Operating Income**	=	**$755,927**

B RUCO OPERATING INCOME ISSUES

1 PROPERTY TAX EXPENSE

Arizona-American and Staff agree on the proper methodology to calculate property taxes.[15] Any differences in the recommended level of property-tax expense appear to result from Staff's slightly lower revenue deficiency.

By contrast, RUCO's methodology to calculate property taxes is one that the Commission has repeatedly rejected, including most recently in Arizona-American's 2007 rate case for its Mohave Water/Wastewater Districts:

> We once again disagree with RUCO's position. RUCO's "study" is flawed because it arbitrarily excludes water systems that do not fit its predetermined result and also reflects retroactive effective dates for rates, in several instances years before the rates were actually in effect. Consistent with numerous prior decisions, we do not believe RUCO's backward-looking methodology properly recognizes that, barring extraordinary circumstances, any increase granted in this case will increase the Company's property taxes. As we stated in the Chaparral City case cited above,

[15] Ex. S-20 at 17:1-6.

> "RUCO's calculation methodology, which uses only historical revenues, unfairly and unreasonably understates property tax expense, and is therefore inappropriate for ratemaking purposes" (Decision No. 68176, 27 at 14). RUCO has not demonstrated a basis for departure from our prior determinations on this issue and we will therefore adopt the recommendations of the Company and Staff to follow Commission precedent and use adjusted test year revenues in determining property tax expense.[16]

RUCO has slightly modified its methodology from the one that the Commission has regularly rejected. It now uses two years of historic data, instead of three, and one year of "RUCO proposed level of revenue."[17] This is a distinction without a difference. RUCO's methodology still largely relies on historic data, despite the fact that the decision in this case will increase revenues, and thereby increase property taxes.

2 ANNUAL INCENTIVE PAY[18]

RUCO would disallow 30% of the Annual Incentive Pay expense – the amount related to Arizona-American's financial performance.[19] Although RUCO consistently rejects precedent concerning property tax, in this one instance RUCO purports to rely on Commission precedent: the Commission's recent rate order for Arizona-American's Paradise Valley Water District.[20] RUCO's reliance is unfounded.

Mr. Coley cites from that decision "…shareholders are the primary beneficiaries of additional profit the Company achieves as a result of meeting its financial targets…. "[21] However, unlike Paradise Valley, the Sun City Water district is a former Citizens property and Arizona-American is unprofitable in this district (and as a whole for that matter).[22] Hence, any increase in net income attributable to employees achieving financial targets only helps reduce

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[16] Decision No. 69440, dated May 1, 2007, at 10:19 - 11:1 (emphasis added). See also, Decision No. 69664, dated June 28, 2007, at 10:21 - 11:2.
[17] R-5 at 23:5-7.
[18] This section, see generally Ex. A-13 at 12:12 - 13:11.
[19] Ex. R-5 at 25:6 – 26:6.
[20] Decision No. 68858, dated July 28, 2006.
[21] Id. at 20:23-25.
[22] Ex. A-4 at 18:25 – 19:2.

losses in this timeframe, not create any profit.[23] In other words, employees met the financial targets established in the incentive plan for Arizona-American by coming closer to plan, not by achieving positive net income.[24] This reduces ongoing equity erosion and helps Arizona-American to achieve the shared goal of a 40% equity ratio.[25] Therefore, it is appropriate to reward employees for reducing losses and helping to create a healthier utility, which is only to the benefit of customers.[26] American Water has shown remarkable restraint during this period of losses by Arizona-American and the Commission can show support for an incentive plan oriented towards long-term recovery rather than short-tem draconian actions.[27]

3 TANK MAINTENANCE

On December 14, 2007, Staff recommended a $27,254 annual amortization expense to recover deferred tank maintenance expense.[28] On December 21, 2007, Arizona-American accepted Staff's recommended level of tank-maintenance expense, which included the $27,254 amortization expense.[29] RUCO does not accept this expense.[30]

RUCO's only explanation for its rejection was that: "RUCO Does Not Accept Co. Late-Filed Tank Maintenance Exp."[31] RUCO's characterization is incorrect – the recommendation was not late filed.

Arizona-American first requested recovery of this expense on November 30, 2007, as part of its regularly scheduled rebuttal testimony.[32] This was more than one month before the hearing. In that time period, Staff was able to verify the propriety of the request, and suggest a

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[23] Ex. A-4 at 19:3-4
[24] *Id.* at 19:5-6.
[25] *Id* at 19:6-8.
[26] *Id* at 19:8-9.
[27] *Id* at 19:10-12.
[28] Ex. S-9 at 9:14-17.
[29] Ex. A-8 at 3:4-7.
[30] RUCO Final Schedule TJC-8, Adjustment 12.
[31] *Id.*
[32] Ex. A-7 at 16:11 – 17:6.

modification, which Arizona-American accepted. In that same time period, RUCO did nothing. Nor did it address the issue in its surrebuttal testimony.

Arizona-American and Staff timely asked to include the $27,254 annual amortization expense to recover deferred tank maintenance expense. The request is supported by the sworn testimony of two witnesses. RUCO has presented no contrary evidence. Therefore, the Commission should accept Arizona-American's and Staff's request.

4 REVENUE AND EXPENSE ANNUALIZATION

This is a relatively minor issue, but it still one that RUCO gets wrong. Arizona-American did not make a customer-annualization adjustment because Sun City has long been built out and is seeing virtually no growth.[33] The Sun City system dates back to 1960 and was Citizens Utilities' (Arizona-Americans' predecessor) first Arizona water utility.[34] The district did add 30 new customers in 2006 and nine through August 2007.[35] However, through normal turnover a built-out community should see years where the number of customers increases, along with years where the number of customers declines. RUCO has not shown that the recent increase was typical or somehow part of a long-term trend. The Commission should reject RUCO's customer annualizations.

5 RATE-CASE EXPENSE AMORTIZATION

All the parties agree on the total amount of allowable rate-case expense. Arizona-American also accepted Staff's proposal to amortize rate-case expense over four years rather than three.[36] RUCO does not accept Staff's proposal to lower the annual expense amortization, but does not explain why.[37]

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[33] Ex. A-7 at 5:7-8.
[34] Ex. A-9 at 3:4-5.
[35] Ex. A-7 at 5:8-9.
[36] Ex. A-5 at 6:3-8.
[37] RUCO Final Schedule TJC-8, Adjustment 9.

6 MISCELLANEOUS EXPENSE

RUCO recommends a miscellaneous expense disallowance of $4,221. Neither Arizona-American nor Staff accept this recommended disallowance.

7 INCOME TAX EXPENSE

Any differences here appear to flow from revenue-requirement differences, not from methodological variations.

IV COST OF CAPITAL

A CAPITAL STRUCTURE

1 ARIZONA-AMERICAN

Arizona-American supports a capital structure of 58.3% debt and 41.7% equity.[38] This reflects an expected 2007 equity infusion of $15,000,000.[39] This equity infusion was completed in December 2007.

2 STAFF

Staff supports a capital structure of 61.0% debt and 39.0% equity.[40] Staff also includes the expected 2007 equity infusion of $15,000,000. [41] The major difference between Staff and Arizona-American is the inclusion of $28,124,006 of short-term debt in Arizona-American's capital structure.[42]

3 RUCO

RUCO supports a capital structure of 57.7% debt and 42.3% equity.[43] This was based on a December 10, 2007, data response from Arizona-American, which stated that the capital structure would be updated.[44] As part of his December 21, 2007, rejoinder testimony Mr.

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[38] Ex. A-5 at TMB-RJ2.
[39] *Id.*
[40] Ex. S-17 at SPI-1. Staff assumes, as do all other parties, that the Tolleson obligation is not included as part of Arizona-American's overall debt
[41] Ex. S-17 at SPI-11.
[42] *Id.*
[43] Ex. R-9 at 5:2-6.
[44] *Id.* at Attachment D.

Broderick updated the capital structure to 58.3% debt and 41.7% equity.[45] This is the capital structure the Commission should approve.

4 DISCUSSION

a SHORT-TERM DEBT

Short-term debt should not be included in Arizona-American's capital structure. This is a new position for Staff in Arizona-American's recent rate cases.

First, short-term debt should not be included in a company's capital structure, unless it is being used to finance long-term assets. Then the return investors expect on rate base should recognize the return expectation of the short-term debt investors.

However, short-term debt is also used to finance working capital and Construction Work in Process ("CWIP"). Short-term debt used to finance working capital and CWIP should not be included in a company's capital structure. To the extent that short-term debt is being used to finance working capital, this is by definition a short-term use. In Arizona, CWIP is not included in rate base, so no return should be provided by customers on CWIP financed by short-term debt.[46] Staff has not met its burden of identifying the balance of short-term debt, if any, being used to finance long-term assets.

A second issue with Staff's inclusion of short-term debt is that short-term debt balances vary widely over the year. Rates should not be set based on a snapshot of a particular short-term debt balance at a particular point of time, unless Staff can show that this level is typical. Staff has not done this.

Unless Staff can show that short-term debt is actually being used to finance long-term assets, and that it has calculated a typical short-term debt balance, then Staff has failed to meet its burden to establish that a particular level of short-term debt should be included in the

[45] Ex. A-5 at TMB-RJ2.
[46] Companies are ultimately compensated for CWIP financing costs by including AFUDC in rate base.

Company's capital structure. The Commission should reject Staff's proposal to include short-term debt in Arizona-American's capital structure.

b COST OF LONG-TERM DEBT

Based on the latest available information, all parties support a cost of long-term debt of 5.50%.[47]

B COST OF EQUITY

1 ARIZONA-AMERICAN

Arizona-American supports Staff's cost-of-equity calculation.[48]

2 STAFF

Staff presented its ROE recommendation through Stephen Irvine, a Public Utilities Analyst IV for the Commission's Utilities Division.[49] Mr. Irvine applied the DCF and CAPM methods and estimated that the estimated industry ROE was 9.9%.[50] Mr. Irvine then added 90 basis points (0.9%) to his base estimate (9.9%) to compensate for Arizona-American's greater leverage than his sample utilities.[51] This yielded Staff's final recommended ROE for Arizona-American of 10.8%.[52]

3 RUCO

RUCO's ROE testimony was presented by William Rigsby, a Public Utilities Analyst V for RUCO.[53] Based on his DCF and CAPM analyses, Mr. Rigsby calculated that the required ROE for his sample group was 9.39%.[54] To this figure, Mr. Rigsby added 50 basis points

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[47] Ex. A-5 at TMB-RJ2; Ex. S-17 at SPI-11; Ex. R-9 at 9:13-19.
[48] Ex. A-4 at 1:18-21.
[49] Ex. S-13, S-15, S-17.
[50] Ex. S-13 at 2.
[51] *Id*.at 35:1:14.
[52] *Id.;* Ex. S-17 at 3:4-5.
[53] Ex. R-8 at 1.
[54] Ex. R-9, Schedule WAR-1 at 3, line 11.

(0.5%) to adjust for Arizona-American's greater leverage.[55] Therefore, RUCO's final ROE recommendation was 9.89%.[56]

4 DISCUSSION

RUCO's ROE calculation is fundamentally flawed. First, Mr. Rigsby's 50-basis point adjustment is arbitrary: it is not based on any recognized methodology.[57] Further, it is inconsistent with Commission precedent. It is well below the basis-point adjustments the Commission has recently approved to compensate Arizona-American's equity investors for additional leverage risk. Nine months ago, the Commission approved a 10.7% ROE for Arizona-American's Mohave Water and Wastewater Districts.[58] This included an adjustment of 100 basis points for Arizona-American's additional leverage risk.[59] With this adjustment, Mr. Rigsby's ROE calculation would be 10.39%.

Mr. Rigsby's base calculation is also flawed. His DCF recommendation equally weighted his DCF evaluations for his water utility samples and his gas utility samples.[60] Unfortunately, his water utility sample only contained four companies.[61] Mr. Rigsby conceded that a larger sample is better.[62] However, he went ahead and weighted this sample equally with his gas utility sample, which contained 10 companies.[63]

Mr. Rigsby should have excluded the results of his DCF analysis for water utilities. Four companies are just not enough. Unusual events at just one company can unduly affect the entire sample, a risk that is smoothed when a larger sample is used. If we just exclude the DCF results for the water-utility sample, Mr. Rigsby's ROE estimate would increase even more

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[55] *Id.* at 3, line 12.
[56] *Id.* at 3, line 13.
[57] Tr. at 769:15-17..
[58] Decision No. 69440, dated May 1, 2007, at 20:7-9.
[59] *Id.* at 18:7-9
[60] Ex. R-9, Schedule WAR-1 at 3, lines 2-4; Tr. at 789:23 – 790:1.
[61] Tr. at 787:9-13.
[62] Tr. at 787:1-8.
[63] Ex. R-9, Schedule WAR-2.

Rigsby DCF Natural Gas Estimate	9.02%
Average of Rigsby CAPM Estimates	10.30%
Average of Rigsby CAPM and DCF Estimates	9.66%
Add: 100 Basis Point Adjustment for Financial Risk	1.0%
Adjusted ROE	**10.66%**

With just these two reasonable adjustments, Mr. Rigsby's estimated ROE would be 10.66%, only 14-basis points lower than Mr. Irvine's 10.80% calculation. The Commission should accept Staff's ROE calculation.

C <u>OVERALL COST OF CAPITAL</u>

Based on the evidence, the overall cost of capital for Sun City Water follows:

	Percentage	Cost	Weighted Cost
Long-Term Debt	58.3 %	5.50 %	3.21 %
Common Equity	41.7 %	10.80 %	4.50 %
Weighted Average Cost of Capital			**7.71 %**

This is certainly a reasonable cost of capital. In fact, it is significantly less than the most recent awards for Arizona's largest utilities.

Utility	Decision No.	Date	Overall Cost of Capital
Arizona Public Service	69663	June 28, 2007	8.32%
Southwest Gas	68487	February 23, 2006	8.40%
UNS Gas	70011	November 27, 2007	8.30%
Large Utility Average			**8.34%**

<u>This is a striking result</u>. Arizona-American's requested cost of capital is 63 basis points <u>less</u> than the average recent awards for Arizona's three largest utilities. Clearly customers are benefitting from American Water's low cost of debt and Arizona-American's leveraged capital structure, which more heavily weights this low-cost debt. In fact, the Commission could justify awarding a 12.30% cost of equity and Arizona-American's customers would pay the same return as that provided to Arizona's large utilities.

	Percentage	Cost	Weighted Cost
Long-Term Debt	58.3 %	5.50 %	3.21 %
Common Equity	41.7 %	12.30 %	5.13 %
Large Utility Average Cost of Capital			**8.34 %**

The Commission should approve a weighted average cost of capital for Arizona-American of 7.71%.

V RATE INCREASE

Based on the evidence Sun City Water is entitled to the following rate increase:

Original Cost Rate Base	$ 25,295,922
Adjusted Operating Income	$ 708,124
Current Rate of Return	2.80%
Required Operating Income	$ 1,950,341
Required Rate of Return	7.71%
Operating Income Deficiency	$ 1,242,216
Gross Revenue Conversion Factor	1.6286
Increase in Gross Revenue Requirement	**$ 2,023,117**

VI RATE DESIGN

A POSITIONS OF PARTIES

1 ARIZONA-AMERICAN AND STAFF

Arizona-American has accepted Staff's recommendation to lower the break-over points between the rate blocks.[64] With that, Arizona-American and Staff should be in agreement concerning the appropriate rate design for Sun City. Arizona-American has submitted its final rate design schedules.[65]

[64] Ex. S-14 at 3:21-4:8; Ex. A-4 at 18:3-8; Ex. A-5 at 6:17-24.
[65] AAW Final Schedules

2 RUCO

RUCO recommends that more revenue recovery should be shifted to the commodity charge.[66] Arizona-American does not believe that further shifts are needed at this time, "given the increase in the last rate block to fund the low-income program and the uncertainty over the future rate design of the fire-flow surcharge."[67] Further, RUCO never directly responded to Staff's proposal (accepted by Arizona-American) to lower the break-over points, but did submit final rate design schedules with different break-over points. The Commission should reject RUCO's recommended rate-design in favor of the rate-design recommended by Arizona-American and Staff.

VII FIRE-FLOW IMPROVEMENTS

A BACKGROUND[68]

In Decision No. 67093 (June 30, 2004), the Commission ordered Arizona-American to form a community task force comprised of a representative of Arizona-American management, and representatives from, at least, Youngtown, Sun City, the Sun City Taxpayers' Association, the Recreation Centers of Sun City, and the fire departments serving Youngtown and Sun City. The purpose of the task force was to determine if water production capacity, storage capacity, water lines, water pressure and fire hydrants were sufficient to provide the fire protection desired in each community. In October 2004, Arizona-American formed the Youngtown/Sun City Fire Flow Task Force ("Task Force") with individual and organizational representatives from the Sun City Taxpayers Association, the Sun City Homeowners Association, the Recreation Centers of Sun City, the Sun City Condominium Association, the Sun City Fire Department, the City of Surprise Fire Department, Youngtown Baptist Village, and the Town of Youngtown.[69]

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[66] Ex. R-6 at 3:5 – 4:22.
[67] Ex. A-5 at 6:12-14.
[68] This Section, see Exhibit A-9 at 3:9 – 5:14.
[69] Exhibit A-9 at 3:18 – 24.

The Task Force met six times from October 2004 to March 2005. The Task Force followed a systematic process that included:

- Reviewing basic water distribution principles;
- Listening to community concerns;
- Reviewing water modeling results from the Sun City District;
- Establishing minimum fire flow standards; and
- Setting priorities for making improvements.

The Task Force concluded that most areas in the Sun City District satisfied the fire-flow requirements recommended by the local fire departments. However, some areas, predominately south of Grand Avenue, need larger pipelines and more fire hydrants to satisfy these recommendations. Based on these conclusions, the Task Force unanimously endorsed a four-year capital improvement plan ("Four-Year Plan) to upgrade the fire-flow capabilities of the Sun City District.

On May 25, 2005, Arizona-American filed a copy of the two-volume Youngstown/Sun City Fire Flow Report ("Task Force Report") with the Commission in Docket Nos. WS-01303A-02-0867, et. al.[70] The Task Force Report's Summary Statement contains a statement of unanimous support from a wide-spectrum of groups and individuals representing Arizona-American's customer base in the Sun City Water District. It also recognized that, while Arizona-American has no regulatory mandate to provide fire flow to the community, adequate fire flow is a public safety issue of importance to the entire community and an issue that should be timely addressed.

The Task Force endorsed a Four-Year Plan that would allow Arizona-American to provide adequate fire flows to all Sun City Water District customers. The Four- Year Plan includes main replacements to improve fire flows and new fire hydrants to provide sufficient access to the water distribution system for fire protection. The Four Year Plan is designed to

[70] Exhibit A-13.

improve those areas with the least fire flow first, with residential areas taking priority over commercial. Overall, ten distinct improvement projects were identified and included 44,133 feet of new main and 195 new fire hydrants throughout the Sun City Water District. Listed by community the improvements will be as follows:

- Sun City: 21,492 linear feet of main and 78 fire hydrants.
- Youngtown: 21,391 linear feet of main and 117 fire hydrants
- Peoria: 1250 linear feet of main.

B PROPOSED CONSTRUCTION BUDGET[71]

The Task Force Report estimated that the cost of the Four-Year Plan would be $3.1 million in 2004 dollars.[72] Because the first year of the plan will not likely be until 2009, Arizona-American provided an updated cost estimate so that the Commission will have all the facts necessary to make its decision. The revised Fire Flow Project cost estimate is $5,118,000.

To arrive at this new estimate, Joseph E. Gross, Arizona-American's Engineering Director, reviewed the estimate contained in the Task Force Report and had discussions with Brown & Caldwell, the engineering firm that provided the original estimate. Mr. Gross made four adjustments to better reflect the total costs of the Fire Flow Project. First, he learned from Brown & Caldwell that the estimate did not include any construction contingencies for utilities conflicts, traffic control, and other unexpected costs. Based on his experience, Mr. Gross concluded that a construction program of this magnitude will incur costs associated with re-routing or altering mains and hydrants locations to avoid conflicts with existing utilities, setting up traffic control notices and barricades, and other unforeseen costs during construction. Mr. Gross believes that it is reasonable to budget 15% of the construction costs as a contingency cost.

Second, Brown & Caldwell's estimate did not take into account the design engineer's construction-administration costs associated with the Fire Flow Project. These costs include

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[71] This Section, see Exhibit A-2 at 4:1 – 5:20.
[72] *Id.* at 5:1-2.

responding to contractors' requests for clarification of the engineer's plans and reviewing submittals for purchase of pipe, hydrants, etc., to insure the equipment meets contract specifications. After reviewing the project scope, Mr. Gross estimated 10% of the construction costs for construction administration.

Third, Mr. Gross added the company's internal costs, such as labor, labor overhead, general overhead, and AFUDC. He estimated this at 15% of the construction cost.

Fourth, Brown & Caldwell's estimate was based on 2004 construction costs. The estimate does not reflect the inflated project construction costs, assuming a start date in 2009 and an estimated completion date in late 2012. Mr. Gross therefore inflated the estimated costs of each project to the year when Arizona-American expects to incur such costs. The inflation factor used in the revised estimate was based upon the Engineering News Record's past construction cost indexes.

Finally, as recommended by Staff witness Dorothy Hains, Mr. Gross identified those hydrant replacements which may be installed simultaneously with pipeline construction, and reduced the costs of these hydrants to the amount recommended by Ms. Hains.

C FUNDING MECHANISM

1 ARIZONA-AMERICAN[73]

Arizona-American proposed to recover the costs of the fire-flow projects through a "fire flow" rate surcharge mechanism that would be transparent on each customer's bill. The surcharge's amount would be set to recover the revenue requirement of the completed fire flow projects. The surcharge mechanism would begin with a Step-1 filing to be made following the completion of phase 1 of the project and so forth for subsequent phases. There would be up to four total step increases possible until completion of the next Sun City Water District rate case to be filed by May 31, 2012. The surcharge would presumably cease following the establishment of new permanent rates in the 2012 rate case (decision anticipated September 2013). The

[73] Exhibit A-3 at 5:11-22.

surcharge would operate nearly identically to the Commission established "ACRM" surcharge, except that it would have more step increases. Just as in a regular rate case, the parties would be able to audit all construction invoices and verify that the projects are in service. The surcharge would not be effective until the Commission issued an order finding that Arizona-American has completed the projects and that the costs are reasonable and prudent.

2 STAFF

Staff reviewed Arizona-American's proposal and found it acceptable, with a few refinements. First, Staff did not support automatic implementation of a step increase after 45 days. Instead,

> Staff prefers adoption of the same format approved for ACRM in Decision No. 66400. Staff agrees with the Company's request for a 45 day review period for each step increase. During this review period, Staff and intervenors would have the opportunity to audit the filing and seek additional discovery relating to the Company's proposed Step Increase. Absent any disagreement between the parties, Staff will issue a recommendation for the Commission's approval. In the event of disagreements between the parties, an accelerated hearing may be requested by any party to the proceeding, to examine the disputed issues. If a hearing is held, the Hearing Division will issue a Recommended Order for the Commission's consideration.[74]

Staff also recommended an earnings test, like the one required for the ACRM filings.

> Staff recommends that the Commission require the Company to submit the same schedules approved for ACRM, demonstrating Sun City Water District's current earnings, at the time of each filing. Staffs recommended earnings test will enable the Commission to determine if the Sun City Water District is over earning its approved rate of return at the time it files for each Step Increase. If the Commission determines that Sun City Water District is over earning its authorized rate of return, its requested Step Increase will be adjusted to reflect excess earnings.

[74] Ex. S-21 at 9:2-10.

Staff's modifications are acceptable to Arizona-American. The earnings test is particularly important for customers. It is essentially a one-sided option where Arizona-American would not be allowed to over-earn, but would provide no relief if the Company were under-earning.

3 ALTERNATIVE FUNDING MECHANISMS

Arizona-American cannot fund the fire-flow projects, unless the Commission approves a mechanism very much like the ACRM. "Arizona-American's present financial condition is so difficult that it cannot undertake any discretionary capital investments in Arizona without immediate rate recovery."[75] "Therefore, if the Commission denies our fire-flow request … Arizona-American will be unable to undertake this discretionary fire-flow improvement project, at least not for many more years."[76]

At the hearing, there were some discussions concerning whether Arizona-American would be able to proceed if the Commission issued an accounting order allowing the Company to defer project costs. Mr. Broderick believed that there would be a significant risk—especially given RUCO's opposition to rate recovery— that Arizona-American could fund the fire-flow projects and then be unable to recover its investment.[77] An accounting order would also provide badly needed cash later than the surcharge mechanism.[78]

Mr. Broderick then checked with senior management to see if Arizona-American would be able to fund the fire-flow projects on the basis of an accounting order. On the last day of the hearing, Mr. Broderick answered "no."

> Q Would Arizona-American Water Company be willing to construct the fire flow projects on the basis of an accounting order?
>
> A No, we would not.
>
> Q And why not?

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[75] Ex. A-3 at 8:1-2.
[76] Exhibit A-3 at 8:20-23.
[77] Tr. at 484:23 – 485:3.
[78] Tr. at 511:24 – 512:1.

A For primarily the reasons I gave the other day which in the interest of time I won't repeat. But since that time, I did speak with senior management – my senior management, that is -- and I received a negative indication from them. We're not willing to undertake this project in this time frame on a deferral basis. I guess I could supplement some of the reasons I've heard. It's quite clear that -- that at the -- at the end of the project, RUCO and possibly some city [sic] commissioners at that time will oppose recovery of expenses no matter what. So that's just an unacceptable risk to the company, and that's my -- that's official company response.[79]

D RATE IMPACT

Exhibit A-15 provides estimates of the percentage rate increases for each of the four step increases. A customer with average consumption of 6,500 gallons per month is estimated to see step increases of 1.5%, 3.1%, 4.8% and 6.8%. A customer with average consumption of 8,700 gallons per month is estimated to see step increases of 1.7%, 3.3%, 5.2% and 7.4%.

E COMMUNITY SUPPORT

As discussed above, the Task Force was comprised of individual and organizational representatives from both Sun City and Youngtown including the Sun City Taxpayers Association, the Sun City Homeowners Association, the Recreation Centers of Sun City, the Sun City Condominium Association, the Sun City Fire Department, the City of Surprise Fire Department, Youngtown Baptist Village, and Town of Youngtown. The Task force unanimously recommended the four-year fire-flow improvement program.

To further gauge community support, Arizona-American surveyed its customers concerning their support of the fire-flow improvements and their willingness to pay for the improvements in their water bills.[80] A majority of customers providing responses supported the improvements and were willing to pay for the improvements.[81] Although no survey is perfect, the results provide additional support for going forward with the improvements.

[79] Tr. at 117:18 – 118:2. (The transcript reference to "city commissioners" should be to "sitting Commissioners.")
[80] Ex. A-4 at 7:22 – 8::3.
[81] Ex. A-5 at 1:17 – 2:17.

Further, all parties to this case support Arizona-American's request, with the exception of RUCO. Arizona-American asks the Commission to approve this request and allow Arizona-American to fund the fire-flow projects identified by the Task Force.

VIII LOW INCOME PROGRAM

Arizona-American proposed a new low-income program for Sun City Water customers. [82] The amount of anticipated low-income discounts is included into the rate design in this case, with the understanding that Arizona-American would refund at a later time over-collection of revenues, if any, should program enrollment be less than the target 1,000 residential customers. Arizona-American is not requesting a pro-forma adjustment to increase test-year expenses for the net costs of this program. Rather, the actual program costs (approximately $30,000) would be eligible for inclusion in the test-year expenses in the next Sun City Water rate case.

Arizona-American proposes a 50% discount on the basic service charge for up to 1,000 eligible residential customers. [83] This would cost roughly $2.29 per year ($50,000/(22,878-1,000)) or $0.19 per month for non-participants. The discount would be recovered through the commodity charge from non-participants, as a further incentive to conserve water usage. Last-block pricing would be raised by $0.047 per 1,000 gallons for non-participant residential and all commercial customers. Based on the rates initially proposed by Arizona-American, the total maximum amount of the discount would be approximately $50,000 annually for 1,000 customers participating year-round.

Ms. Cindy Datig of the $1 Energy Fund, Inc. ("$1 Energy"), provided details of how customer eligibility would be determined and how the program would be administered.[84] An eligible Sun City Water District customer must be a full-time Sun City resident, who is the primary account holder over 65 years of age. In addition, the eligible customer's annual

[82] This paragraph, see Ex. A-4 at 15:6-19.
[83] This paragraph, see Ex. A-4 at 16:6-17.
[84] Exhibit A-1

household income cannot exceed 150% of the Federal Poverty Income Guideline ("FPIG"). $1 Energy will work with Arizona-American to confirm eligibility and administer the program.

There does not appear to be any opposition to the proposed program. Arizona-American asks the Commission to approve the Company's request to implement the low-income program.

IX **CONCLUSION**

Arizona-American is one of Arizona's premier water companies, yet is also a distressed utility. Arizona-American shares the Commission's goal of returning to financial health by, in part, improving its equity ratio. To that end, Arizona-American's parent infused $35 million in new equity into the Company in March 2006 and Arizona-American has suspended dividends for the last four years. Another $15 million equity infusion was completed in January 2008. However, Arizona-American cannot return to financial health without the Commission's assistance. Timely rate relief is a must, including recovery of previously excluded investments, prudently incurred expenses, and a return on equity that properly compensates equity investors for leverage risk.

This is another in a series of rate cases that are critical in returning Arizona-American to financial health. It is an opportunity for the Commission to send the message that it cares about one of its premier water companies and that it will set rates in a manner that will allow it to return to financial health.

RESPECTFULLY SUBMITTED on February 13, 2008.

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